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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1957.

**No. 410.**

MOLLY G. BESS, PETITIONER,

*vs.*

UNITED STATES OF AMERICA.

**No. 395.**

UNITED STATES OF AMERICA, PETITIONER,

*vs.*

MOLLY G. BESS.

*ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

## BRIEF FOR MOLLY G. BESS, CROSS-PETITIONER IN NO. 410 AND RESPONDENT IN NO. 395.

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MOLLY G. BESS.

## BRIEF FOR MOLLY G. BESS, CROSS-PETITIONER IN NO. 410 AND RESPONDENT IN NO. 395.

### Opinions Below.

The opinion of the Court of Appeals (R. 17-22) is reported in 243 F. 2d 675. The opinion of the District Court (R. 10-16) is reported in 134 F. Supp. 467.

## Jurisdiction.

The judgment of the Court below (R. 23) was entered March 28, 1957. Rehearing was denied (R. 28) May 20, 1957. On August 9, 1957, by order of Mr. Justice William J. Brennan, Jr., the time within which to file petition for a writ of certiorari was extended to September 19, 1957 (R. 31). The cross-petition was filed on August 22, 1957, and was granted October 28, 1957 (R. 31). The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

## Questions Presented.

Herman Bess, deceased husband of the petitioner, was indebted to the United States for Federal income taxes. The assets of his estate were insufficient to pay the income tax debt in full. His life was insured under several life insurance policies over which, at the time of his death, he had the right to change the beneficiary, to borrow against the cash surrender values and the right of assignment. The petitioner, having been named as beneficiary when the policies were taken out, collected the proceeds when the policies matured at death of the insured. Herman Bess was solvent at all times when he paid the insurance premiums. There was no fraud against creditors in taking out the insurance, in naming the petitioner as beneficiary, nor in paying the premiums, nor did any such act render Herman Bess insolvent.

1. The question presented in No. 395 and No. 410 is whether the cross-petitioner, Molly G. Bess, is liable either

in law or in equity for the unpaid income tax debt of her deceased husband, Herman Bess, to the extent of any part of the proceeds paid to her as beneficiary of insurance policies on his life, the premiums for which he paid when he was solvent and without fraud of creditors.

## Statutes Involved.

SEC. 3670. PROPERTY SUBJECT TO LIEN.

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person (53 Stat. 448, 26 U. S. C. 1952 ed., sec. 3670).

SEC. 1652. CIVIL PROCEDURE ACT.

The laws of the several states, except where the Constitution or Treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply (62 Stat. 944, 28 U. S. C. Sec. 1652).

New Jersey R. S. 17:34-28. BENEFICIARY'S RIGHT TO PROCEEDS.

When a policy of insurance is effected by any person on his own life, or on another life in favor of a person other than himself having an insurable interest therein, the lawful beneficiary thereof, other than himself or his

legal representatives, shall be entitled to its proceeds, against the creditors and representatives of the person effecting it. The person to whom a policy of life insurance is made payable may maintain an action thereon in his own name. Subject to the statute of limitations, the amount of any premiums for the insurance paid in fraud of creditors, with interest thereon, shall, however, inure to their benefit from the proceeds of the policy; but the company issuing the policy shall be discharged of all liability thereon by payment of its proceeds in accordance with its terms, unless, before the payment, the company shall have written notice by or in behalf of some creditor, with specification of the amount claimed, claiming to recover for certain premiums paid in fraud of creditors.

Source. L. 1902, c. 134, Sect. 38, p. 422 (C. S. p. 2850, Sect. 38).

New Jersey R. S. 17:34-29. Policies to Inure to Benefit of Married Woman.

Every policy of life insurance made payable to or for the benefit of a married woman, or after its issue assigned, transferred or in any way made payable to a married woman, or to any person in trust for her or for her benefit, whether procured by herself, her husband or by another person, and whether the assignment or transfer is made by her husband or by another person, shall inure to her separate use and benefit, and to that of her children, according to the terms and provisions of the policy or assignment, subject to the foregoing provisions relating to premiums paid in fraud of creditors.

Source. L. 1902, c. 134, Sect. 39, p. 422 (C. S. p. 2850, Sect. 39).

## Statement.

1. *Nature of the action.*—This action was instituted by complaint filed in the United States District Court, District of New Jersey, by the United States of America, as plaintiff, against Molly G. Bess, as defendant, who is hereinafter referred to as cross-petitioner. The complaint alleged that the cross-petitioner was a transferee of property of Herman Bess, deceased, by virtue of having been beneficiary of his life insurance, and thus liable, at law or in equity, for the unpaid income tax owing by said Herman Bess, deceased.

No action was taken by the Commissioner of Internal Revenue to assess the transferee liability against the cross-petitioner, Molly G. Bess, under the provisions of Section 311 of the Internal Revenue Code of 1939 (R. 10, par. 31).

2. *The facts.*—The case was tried on a stipulation of facts (R. 3-10).

Cross-petitioner, Molly G. Bess, is the widow of Herman Bess, a resident of New Jersey, who died June 29, 1950. At the time of his death, there were in effect nine life insurance policies on the life of Herman Bess, in one of which his estate was named as beneficiary and in eight of which the cross-petitioner was named as beneficiary. The cross-petitioner was designated as the beneficiary of such policies when they were issued and remained continuously as such beneficiary until the insured's death, except for immaterial, temporary changes respecting two policies (R. 6-9, Opinion; R. 17, 18). Seven of such policies were issued during 1934, 1935, 1936 and 1937. The eighth, a group insurance policy

with no cash value, was issued June 19, 1950 (R. 6-9, Opinion, R. 17, 18).

Herman Bess retained the right to change the beneficiary of the policies and also retained the right to borrow upon the security of the cash surrender value of the seven policies described first herein (Opinion, R. 17, and R. 6-9, pars. 18-28).

Herman Bess paid all of the premiums until his death out of his own funds. He was solvent, at all times, when such premiums were paid (R. 9, par. 30).

At the time of his death Herman Bess owned in joint tenancy with the cross-petitioner, his wife, real estate with a net equity value of $52,054.48, and personal property with a value of $3,187.15 (R. 6, par. 17). In addition, Herman Bess owned other assets which became part of his estate (R. 5, par. 11). His estate also collected the proceeds of the ninth life insurance policy in which his estate was designated as beneficiary (R. 6-7, par. 19).

On July 17, 1952 the Monmouth County Court, Probate Division, adjudged the estate of Herman Bess as insolvent (R. 5, par. 12).

After paying the funeral and administration expenses all of the remaining assets of the estate were applied toward payment of income tax balances assessed against Herman Bess. After crediting such payments there remained due, on account of such taxes, a total of $8,874.57, reflecting balances of $4,159.31 for 1945, $3,789.32 for 1946 and $925.94 for 1947 (R. 11), the entire balances owing for 1948 and 1949 having been paid in full, and the balance for 1945 having been reduced.

3. *The District Court decision.*—The learned Trial Judge concluded that *Pearlman* v. *Commissioner,* 153 Fed. 2d 560, 3 Cir., laid down a broad policy imposing transferee liability upon a life insurance beneficiary to the full extent of the life insurance proceeds, without regard to the provisions of State Law, and with no particular significance attached to the solvency or insolvency of the deceased taxpayer. On the basis of the *Pearlman* decision, which the learned Judge decided was controlling here, he rendered judgment against the cross-petitioner in the amount of $11,657.30 (Opinion, R. 14, 15; Judgment, R. 16).

4. *The Court of Appeals decision.*—The Court decided that the cross-petitioner was not a transferee of the proceeds of the policies (Opinion, R. 21).

Holding, however, that "since there was a Federal tax question to be decided it should be decided on general law as laid down by the Federal courts and not be subject to the limitation in the law of any state" (Opinion, R. 19), the Court decided that Herman Bess was insolvent at the time of his death, and that the cross-petitioner was liable as a transferee of $3,362.53, the cash surrender or loan value of the insurance policies at the time of death (Opinion, R. 22).

In footnote 2 (Opinion, R. 19, 20) the Court indicated that the cross-petitioner is not liable to any extent if the New Jersey law is applicable.

## Summary of Argument.

### I.

### The Transferee Theory.

On the facts of this case the cross-petitioner is not under any liability to the United States as transferee of Herman Bess whether the decision is made under general law laid down by the Federal Courts, as the Court below decided, or under State law, as the cross-petitioner urges.

The question in the case at bar should be decided under the law of New Jersey because:

(1) Title 28, Section 1652, U. S. C. provides, and this Court in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64*, held that the laws of the several states, except where the Constitution or Treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the Courts of the United States, in cases where they apply.

(2) No section of the Federal Revenue Act which might apply to the case at bar defines the standards to be applied, the terms used, or the property which they affect. An inquiry into State law is inescapeable in order to determine the application of the Federal Revenue Act when that Act fails to provide its own definition, *Helvering* v. *Fuller*, 310 U. S. 69, 74; *Morgan* v. *Commissioner*, 309 U. S. 78 and other cases cited in the argument.

(a) In footnote 3 of its opinion (Opinion, R. 19) the Court below correctly stated that if the law of New Jersey is applied then the cross-petitioner is under no liability to the United States. The basis for such a decision, if New

* The *Erie* doctrine would appear to be applicable whenever state created rights are in issue regardless of basis for federal jurisdiction. 62 Harvard Law Rev. 1030, 1031, footnote 6.

Jersey law is applicable, is the New Jersey Statute, namely, N. J. Revised Statutes, Sections 17:34-28 and 17:34-29 and the decisional law of the New Jersey Courts.

(b) The Court below has not correctly applied the general law as laid down by the Federal Courts, and particularly as laid down by this Court in *Central Bank of Washington* v. *Hume*, 128 U. S. 195 (1888). The *Hume* case laid down the rule that actual fraud must be established as the basis for recovery from a wife-beneficiary since fraud will not be imputed to a married man from the mere fact of payment, at a time when he is insolvent, for life insurance taken out to protect his wife and children. The reason for the rule is that public policy imposes a legal obligation upon a married man to provide against the destitution of his wife and children. Whether the test laid down in the *Hume* case is applied, with respect to premium payments, as of the time of such payments as this Court held in *Hume*, or is applied, with respect to cash surrender value, as of the time of death as the Court below held in the case at bar, the cross-petitioner is under no liability because there is no allegation, evidence nor hint of fraud on the part of either Herman Bess or the cross-petitioner at any time. Furthermore, the stipulation admits that Herman Bess was solvent at all times when premiums were paid (R. 9, par. 30). It is urged that Herman Bess was also solvent at the time of his death, although the Court below inferred that he was insolvent (Opinion, R. 22), because in addition to his substantial property interests (R. 5, par. 11 and R. 6, par. 17), he also had substantial amounts of income as reflected by the income taxes.

## II.

### The Tax Lien Theory.

2. The tax lien theory, under Section 3670 Internal Revenue Code of 1939, which the Government in its petition for certiorari reserved the right to assert as an alternative basis for recovery (Pet. for cert., No. 395, footnote 2, p. 4), should not be entertained as a basis for recovery on appeal because it was not asserted as a basis for recovery before the Trial Court; and especially because the case was submitted for decision to the Trial Court on a stipulation of facts which was, in good faith, drafted to present facts relevant to the issue presented for decision. See *General Utilities & Operating Co.* v. *Helvering*, 296 U. S. 200 (1935).

3. Moreover, the Government is not entitled to recover on the merits of the lien theory.

In the first place, it has not been established that the taxpayer, Herman Bess, neglected or refused to pay his tax, which the statute imposes as conditions precedent to the creation of the statutory lien. On the contrary, the stipulation admits that the taxpayer, Herman Bess, until his death made periodic payments on account of the tax. Therefore, the facts establish that the taxpayer was acting in good faith, and was neither neglecting nor refusing to pay the tax.

4. In the second place, the beneficiary is entitled to the proceeds, even to the exclusion of an assignee of the policy, under the decisional law of New Jersey, which is applicable because the lien statute does not define the property or rights to property to which the lien may attach. See *Anderson* v. *Broad St. National Bank*, 90 N. J. Eq. 78, affirmed 91 N. J. Eq. 331, and others cited in the argument.[1]

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[1] Cf. *Poe* v. *Seaborn*, 282 U. S. 101, 118; *Morgan* v. *Commissioner*, 309 U. S. 78; *Helvering* v. *Fuller*, 310 U. S. 69, 74.

## III.

### The Amount of Liability.

5. If the Court decides the basic issue of liability in favor of the cross-petitioner then the question raised in No. 395 with respect to the amount of the liability need not be considered.

However, if it is decided that the cross-petitioner is under liability as a transferee, the amount of such liability is limited to the value of the transferred property. *Voss* v. *Wiseman*, 234 F. (2d) 237 (10 Cir. 1956); *Borg* v. *McCroskery*, 120 N. J. Eq. 80, 86 (1936).

Since the proceeds were not, and never could be, the property of Herman Bess, the proceeds were not property transferred by Herman Bess to the cross-petitioner, and the Court below so decided (Opinion, R. 21). This finding accords with *U. S.* v. *New*, 217 F. (2d) 166 (7 Cir. 1954) and *U. S.* v. *Truax*, 223 F. (2d) 229 (5 Cir. 1955).

The Court below decided that cash surrender value of the policies was the item of property which was transferred to the cross-petitioner (Opinion, R. 22). It is urged that in no event does the transfer consist of more than the premiums or the cash surrender value, and liability, if it properly exists on account of such a transfer, is limited to the premium payments or cash surrender value.

# ARGUMENT.

## POINT 1.

**The wife of an insured debtor, who as beneficiary collects on husband's life insurance, is not liable to her husband's creditors as a transferee of property of her husband, in the absence of fraud, either**

**(a) Under the law of New Jersey, or**

**(b) Under general law as laid down by the Federal Courts.**

The Court below decided that the question of liability in this case is to be answered without referring to state law.

The cross-petitioner urges that whether she is a transferee and whether, and to what extent, she is liable as such a transferee is a question to be decided in accordance with the law of New Jersey where she and the alleged transferor resided.

With the exception of the Court below, all other Courts of Appeal which have decided the question hold that State rather than Federal law determines the substantive liability in transferee cases.[2] This Court, in *Philips* v. *Commissioner*, 283 U. S. 589, 602, reserved the question.

With respect to the transferee theory the Government has not invoked any section of the Federal statutes. Paragraph 31 of the Stipulation (R. 10) admits that no transferee assessment under Section 311 of the Internal Revenue Code of 1939 was proposed against the cross-petitioner.

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[2] *Tyson* v. *Commissioner*, 212 F. (2d) 16 (6 Cir.); *Rowen* v. *Commissioner*, 215 F. (2d) 641 (2 Cir.); *U. S.* v. *Neic*, 217 F. (2d) 166 (7 Cir.); *U. S.* v. *Truax*, 223 F. (2d) 229 (5 Cir.); *Stern* v. *Commissioner*, 242 F. (2d) 322 (6 Cir.).

The Civil Procedure Act, 62 Stat. 944, 28 U. S. C. Section 1652 (formerly Section 34, of Rules of Decision Act of 1789, 1 Stat. 92), provides:

> "The laws of the several states, except where the Constitution or Treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply.".

Referring to Section 34 of the Federal Judiciary Act of 1789, the predecessor to the present statute quoted above, Justice Brandeis in his opinion for this Court in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 72 (1938), quoted with approval from an earlier decision of this Court as follows:

> "The statute, however, is merely declarative of the rule which would exist in the absence of the statute." *Mason* v. *U. S.*, 260 U. S. 545, 559.

There is no privity, in this case, between the United States of America and the cross-petitioner, based either upon a statute, contract, or other direct relationship. The alleged claim against the cross-petitioner is derivative, since it is based upon the fact that the United States is a creditor of Herman Bess. Regardless of the origin of the debt, with respect to the cross-petitioner the United States has no greater rights than any private creditor of Herman Bess might have under the same circumstances. To hold otherwise, would clothe the Government with rights and privileges not conferred upon it by the Constitution. In *U. S.* v. *Scott*, 167 F. (2d) 301, 8 Cir. (1948), the Court ruled that an action by the United States against a third party to recover for taxes owed by a taxpayer, as against the

third party, is for collection of a debt rather than collection of taxes, and held that the liability should be determined in accordance with State rather than Federal statutes.

Furthermore, as the Court pointed out in *Rowen v. Commissioner*, 215 F. (2d) 641, 2 Cir., the question of liability even under Section 311 of the Internal Revenue Code, should be determined in accordance with the law of the applicable state because that statute does not define how the liability shall be determined.

In its prior arguments the Government has contended that a trust was impressed upon the property of Herman Bess which followed into the proceeds of the life insurance policies. No basis, nor authority, can be found for holding that such a trust is imposed upon the proceeds. Certainly, an implied constructive trust can arise only with respect to money stolen or otherwise wrongfully obtained by the transferor, who never acquired title and therefore could not transfer title. Nor can there be a resulting trust, since there was no intention on the part of Herman Bess, that the proceeds of the life insurance be held for the benefit of himself or his creditors.

Glenn, in Fraudulent Conveyances and Preferences wrote concerning creditor's rights in life insurance proceeds:

> "The creditor, * * *, is not like the cestui que trust who traces misappropriated funds for the reason that, as we have seen, a debtor does not hold his testate in trust for creditors. If a trustee pays premiums out of misappropriated trust funds, the beneficiary may take over the policy itself. But the creditor who shows that payment of a premium was a fraudulent conveyance is entitled only to a return

of what his debtor transferred, and so his claim is limited by that amount. This seems to be the sound view and it is supported by good authority." Glenn, Fraudulent Conveyances and Preferences, Revised Ed., vol. 1, section 178, p. 323. See also *Shaler* v. *Trowbridge*, 28 N. J. Eq. 595 (E. & A. 1877), in which a constructive trust was imposed upon insurance acquired with embezzled funds.

**(a) New Jersey law.**

A wife-beneficiary of life insurance on her husband's life is not liable for her husband's debt, as a transferee of his property, in the absence of fraud, under New Jersey law.

In footnote No. 3 to the Opinion (opinion, R. 13), the Court below correctly stated that no liability attached to the cross-petitioner if New Jersey law is applicable.

The applicable law of the State of New Jersey is contained in Sections 28 and 29, Chapter 34, Title 17 of the New Jersey Revised Statutes, *supra*, pages 3, 4 of this brief, and the decisions of the New Jersey courts which have construed the statute.[3]

The Court below, however, ruled that the question in this case is one to be answered without referring to State law limitations. The Court below may have accepted the view urged by the Government that the New Jersey statute is an exemption statute, and is not to be applied against the Government. In stating its view the Court below referred to its prior decision in *Pearlman* v. *Commissioner*, 153 F. (2d) 560 in which the Pennsylvania statute which exempts

[3] *Sullivan* v. *Maroney*, 76 N. J. Eq. 104, 109, 73 A. 843, 844 (1909); *Borg* v. *McCroskery*, 129 N. J. Eq. 80, 184 A. 187.

the entire proceeds, was involved. Unlike the Pennsylvania statute, which exempts the entire proceeds, the New Jersey statute provides a logical rule for marshalling the proceeds between the beneficiary and creditors in accordance with the rule established by this Court in *Central Bank of Washington* v. *Hume*, 128 U. S. 195 (1888). The New Jersey statute was first adopted in 1896, within one year after the Court of Chancery in *Merchants' & Miners' Transportation Co.* v. *Borland*, 53 N. J. Eq. 282 (1895), disagreed with the rule of the *Hume* case. Within one year after the decision in *Merchants' & Miners' Transportation Co.* v. *Borland*, *supra* "and probably because of it, the Legislature passed P. L. 1896, p. 240, to declare rights as between an insured's creditors and his beneficiary * * * and that statute was incorporated as part of the Insurance Act of 1902 (Comp. Stat. p. 2836) * * * " (now R. S. 17:34-28 and 17:34-29). Quotation taken from *Borg* v. *McCroskery*, 120 N. J. Eq. 80, 83, 84.[4]

**(b) General law as laid down by the Federal Courts.**

If the question is to be decided in accordance with general law as laid down by the Federal Courts, as the Court below concluded, then the rule laid down by this Court in *Central Bank of Washington* v. *Hume*, 128 U. S. 195 (1888), is expressive of such general law, and is controlling.

In the *Hume* case, this Court, basing its decision upon sound public policy, enunciated a rule which, at the time, some criticized as a variation from the traditional interpretation of a creditor's right to reach a fraudulent convey-

[4] See also, Glenn, Fraudulent Conveyances and Preferences, revised ed., vol. I section 177, p. 322, and Vance, Insurance (2d ed.) p. 624.

ance.[5] However, the social policy was sound and the rule responded to public need. It was soon followed by State Courts, and adopted by Legislatures in various states so that the rule of the *Hume* case has become the majority view, cf. "Fraudulent Conveyances", 25 Virginia Law Review, 588, 593 (1939).

In the *Hume* case a creditor sought to reach proceeds of the debtor's life insurance collected by the debtor's wife as the beneficiary. Pointing out that it is the fraudulent intent of the donor which vitiates a transfer and that such fraudulent intent is conclusively presumed if the donor is actually insolvent the Court wrote (*Central Bank of Washington* v. *Hume*, 128 U. S. 195):

> "But the circumstances of each particular case should be considered, as in Patridge *v.* Gopp, 1 Eden, 163, Amb. 596, where the Lord Keeper, while holding that debts must be paid before gifts are made, and debtors must be just before they are generous, admitted that the fraudulent intent might be collected from the magnitude and value of the 'gift' ". 128 U. S. 195, 211.

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Deciding how to apply the rule so stated, to life insurance, the Court, in the *Hume* case wrote:

> "It seems to us that the same public policy which * * * recognizes the support of wife and children as a positive obligation in law as well as morals, should be extended to protect them from destitution after the debtor's death, by permitting him, not to accumulate a fund as a permanent provision, but to devote a moderate portion of his earnings to keep on foot a security for support already, or which could thereby

[5] Williston, American Law Review, volume 25, p. 185; *Merchants' & Miners' Transportation Co.* v. *Borland*, 53 N. J. Eq. 282.

be lawfully obtained, at least to the extent of requiring that, under such circumstances, the fraudulent intent of both parties to the transaction should be made out." 128 U. S. 195, 211, 212.

The Court in the *Hume* case recognized the payment of premiums as the time and subject of the transfer. Some courts have decided that a transfer occurs at the time when an insured changes the beneficiary from the executors of his estate to some other person. *Rowey* v. *Commissioner*, 215 F. (2d) 641, 2 Cir. (1954); *Pearlman* v. *Commissioner*, 4 T. C. 34.

In the instant case, the Court below decided that a transfer of the cash surrender value occurred at the moment of death.

It is respectfully urged that termination of the insured's control of the policy, as the result of his death, is not that affirmative act of transfer contemplated as the basis for recovery by a creditor.

Those cases which involve the imposition of the Federal Estate Tax are not apposite since the estate tax applies not only with respect to property transferred at death but also with respect to property control over which is terminated at death. *Chase Nat. Bank* v. *United States*, 278 U. S. 327, see also section 811 (f), Internal Revenue Code of 1939, respecting property subject to power of appointment.

The stipulation admits that Herman Bess was solvent at all times when he paid premiums (R. 9, par. 30). At the time of his death he owned in joint tenancy with the cross-petitioner, his wife, real estate with a net equity value of $52,054.48, and personal property with a value of $3,187.15 (R. 6, par. 17). He also owned other assets (R. 5, par. 11).

In addition it can be inferred from the size of his income taxes that he also earned substantial income. From July 30, 1948 until his death, by virtue of periodic payments, he reduced his back taxes by $6,800.41 (R. 4, par. 5). There has been no allegation, evidence nor hint of fraud at any time. Under those circumstances, applying the rule of law laid down in *Central Bank of Washington* v. *Hume*, 128 U. S. 195, there has been no fraudulent transfer, either of the premiums when paid, or the cash surrender value at death, which the Government can recover from the cross-petitioner.

## POINT 2.

**The Government cannot on appeal properly assert as an alternative basis for recovery, a basis for recovery which was not raised in the pleadings nor presented to the trial Court.**

In its petition for certiorari, No. 395, the Government reserved the right to assert as an alternative basis for recovery that a lien, pursuant to Section 3670 Internal Revenue Code, of 1939, attached to the property of Herman Bess, and that this was a proceeding to enforce the lien.

The "tax lien theory" was not asserted in the Complaint which initiated this proceeding, nor in any other pleadings before the trial Court. It was not presented to, considered by nor ruled upon by the trial Court. Therefore it is urged that this question should not be entertained, or considered as a basis for decision by this Court, especially because the case was submitted for decision to the trial Court on a stipulation of facts which was, in good faith,

drafted to present the facts relevant to the issue presented for decision. See *General Utilities & Operating Co.* v. *Helvering*, 296 U. S. 200 (1935).

## POINT 3.

**No lien arose under Section 3670, since the facts do not establish the statutory prerequisites, namely, neglect or refusal of the taxpayer to pay the tax.**

The lien under Section 3670 is predicated upon a condition precedent, namely, "If any person liable to pay any tax neglects or refuses to pay the same after demand * * *".

Had Congress intended to create a lien based upon the mere fact of a tax debt, standing unpaid by itself, it would not have used the conditional "if" followed by the definition of the circumstances, namely, neglect or refusal to pay, upon which the condition turns.

"Neglect" is defined in Funk & Wagnalls Practical Standard Dictionary as follows:

> "Neglect. 1. To fail to treat with attention.
>
> 2. To ignore.
>
> 3. To fail to perform through carelessness or oversight."

"Refuse" is defined in Funk & Wagnalls Practical Standard Dictionary as follows:

> "Refuse. 1. To decline to do, permit, or yield.
>
> 2. To reject; deny; repel."

Cross-petitioner invites the Court's attention to the pertinent language found in the recent opinion, *In the matter of Clinton Crockett, etc.*, 150 F. Supp. 352 (1957):

> "In order for the lien of Sec. 3670 (I. R. C. 1939) to attach to the individual property of the bankrupt, it must be established that (1) he is a 'person liable to pay' the tax, and (2) he has 'neglected or refused to pay the same after demand'." 150 F. Supp. 352, 354.

And:

> "(5) It cannot be determined, however, on the record now before this Court, whether petitioner has perfected the lien it asserts against the bankrupt's property. By the plain wording of Sec. 3670, *supra*, the lien does not attach unless and until the delinquent taxpayer 'neglects or refuses to pay the same after demand'. It is incumbent upon petitioner to show that these statutory prerequisites have been fulfilled before the Referee can treat petitioner as a lien creditor." 150 F. Supp. 352, 354.

The Government has the burden of affirmatively establishing the existence of neglect or refusal as a prerequisite to the arising of the lien, under the clear language of the statute. Not only has the Government failed to establish either "neglect" or "refusal" to pay, but it is suggested that the fact of the periodic payments, amounting to $6,800.41, made by Herman Bess, after simultaneous assessment and demand respecting the 1945 and 1946 taxes (R. 4, pars. 5 and 6), until his death as admitted in paragraph 5 of the Stipulation (R. 4) can only serve to establish that he was complying in good faith, and probably with the consent of the Collector of Internal Revenue both as to the amounts and manner of payment. 1947 tax was assessed after date of his death (R. 5, par. 8).

## POINT 4.

**No lien in favor of the Government has attached to, nor followed into the insurance proceeds.**

Whether the Government, when it has properly established that a lien arose under Section 3670 against an insured taxpayer, can collect the amount of its lien, after the taxpayer's death, from the beneficiary of the life insurance presents a question not previously decided by this Court. The question was decided favorably to the Government in *U. S.* v. *Behrens*, 230 F. (2d) 504, 2 Cir., affg. 130 F. Supp. 93, cert. den. 351 U. S. 919, and was followed by *U. S.* v. *Hoper*, 242 F. (2d) 468, 7 Cir., reversing 144 F. Supp. 281. Those cases involved residents of New York and Illinois, respectively. In order to develop this argument; in what is believed to be logical order, comment respecting the *Behrens* and *Hoper* cases is withheld at this point, and is taken up on page 27 of this brief.

It is urged, as indicated by the argument which follows, that the property rights to which the statutory lien attaches are to be determined in accordance with the law of the applicable State. In the instant proceeding, the applicable State law is that of New Jersey. If the law of New Jersey is applied, as the cross-petitioner urges is required, then the Government cannot recover from the cross-petitioner under the lien of Section 3670.

Section 3670 provides a lien, when the conditions precedent are established, "upon all property and rights to property whether real or personal". Neither that section nor any other defines the terms "property and rights to property."

The rule is well established that where the Revenue Act does not define the property and interest in property to which it is intended to apply, the meaning of the words must be determined pursuant to the law of the applicable State.

In the application of the income tax law this Court has held that rights to and ownership of property should be decided in accordance with state law. When the Revenue Act provides no definition, resort to State law is inescapable. *Helvering* v. *Fuller*, 310 U. S. 69, 74.[6]

In *U. S.* v. *Penn Mutual Life Insurance Co.*, 3 Cir., 130 F. (2d) 495 and *Karno-Smith Co.* v. *Maloney*, 3 Cir., 112 F. (2d) 690, it was held that property rights are to be determined in accordance with State law even where the United States or the Collector of Internal Revenue seeks to assert its tax lien. Cf. also *Cannon* v. *Nicholas*, 10 Cir., 80 F. (2d) 934, 936 (1935).

The insurance policy is a contract. The law of the State is as much a part of the contract as if it were incorporated into the insurance policy itself, *Central Bank of Washington* v. *Hume*, 128 U. S. 195. It follows, then, that all parties to the contract, including a lienor who claims derivatively by virtue of a lien against the insured, are governed by and have only those rights and property interests which are conferred under the provisions of the contract as interpreted by the law of the State.

The Courts of New Jersey have continuously held, in a long line of cases, that an individual who is designated as a beneficiary in a policy of insurance holds a property

[6] See, *Freuler* v. *Helvering*, 291 U. S. 35; *Blair* v. *Commissioner*, 300 U. S. 5; *Poe* v. *Seaborn*, 282 U. S. 101.

right which can only be divested by making a change of beneficiary in the manner provided by the policy contract and that the beneficiary takes the proceeds even to the exclusion of the assignee-owner of the policy if death occurs before the beneficiary is changed,[7] on the premise that the respective rights of the parties are governed by the intention as expressed in the policy contract.

Other states also subscribe to the same rule.[8] Some states hold to the contrary on the premise that when an insured assigns the policy he intends that the assignee shall receive the proceeds.[9]

In *Anderson* v. *Broad St. National Bank*, 90 N. J. Eq. 78, affirmed, 91 N. J. Eq. 331, the insured having reserved the right to change the beneficiary, and the right to assign the policy, made an assignment of the policy to a bank as security for a loan. The insured's wife was beneficiary of the insurance policy prior to its assignment of the bank. No change of beneficiary was thereafter made. The question before the Court was whether the wife, as beneficiary, or the bank, as assignee, of the policy was entitled to the proceeds. Holding that the assignment of the policy did

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[7] *Metropolitan Life Insurance Co.* v. *Woolf* (New Jersey Court of Errors and Appeals 1946), 138 N. J. Eq. 450, 47 A. 2d 340; *Metropolitan Life Insurance Co.* v. *Clanton*, 76 N. J. Eq. 4, 73 A. 1052; *Sullivan* v. *Maroney*, 76 N. J. Eq. 104, 73 A. 842, affirmed 77 N. J. Eq. 565, 78 A. 150; *Anderson* v. *Broad Street National Bank*, 90 N. J. Eq. 78, 105 A. 599, affirmed 91 N. J. Eq. 331; *Union Central Life Insurance Co.* v. *Elizabeth Trust*, 119 N. J. Eq. 505, 183 A. 181; *Prudential Insurance Co.* v. *Mantz*, 128 N. J. Eq. 480, 486.

[8] *Muller* v. *Penn. Mutual Life Ins. Co.*, 62 Colo. 245, 161 Pac. 148 (1916); *Johnson* v. *New York Life Ins. Co.*, 56 Colo. 178, 138 Pac. 414 (1913); *Shum* v. *Lawrenceburg Nat. Bank*, 314 Ky. 297, 234 S. W. 2d 962 (1950); *Douglas* v. *Equitable Life Assur. Soc.*, 150 La. 519, 90 So. 834 (1922); *Citizen's Bank* v. *Knight*, 15 La. App. 62, 130 So. 270 (1930); *Finnegan* v. *Prudential Ins. Co.*, 300 Mass. 147, 14 N. E. 2d 172 (1938); *Goldman* v. *Moggs*, 287 Mass. 393, 191 N. E. 873 (1934).

[9] *Equitable Life* v. *Mitchell*, 248 Ill. app. 401 (1927); *Davis* v. *Modern Ind. Bank*, 279 N. Y. 405, 18 N. E. 2d 639 (1939); *Cummins Estate*, 200 Misc. 467, 105 N. Y. S. 2d 104 (1951).

not divest the interest of the beneficiary, the learned Vice Chancellor wrote:

> "After a careful examination of the authorities, I am of the opinion that whether the interest be regarded as vested and defeasible, contingent, a mere expectancy, or whatever the characterization may be, if the policy stipulates the course by which the beneficiary's interest is to be nullified, he cannot be deprived of his right unless the prescribed mode for its destruction is followed, and that the assignment in this case by the assured had not that effect." *Anderson* v. *Broad St. National Bank*, 90 N. J. Eq. 78, 82.

It has been held that unless the insured has exercised his option to surrender the policy for cancellation, there is no money owing to him, and there is no fund to which the statutory lien can attach, *U. S.* v. *Metropolitan Life Ins. Co.*, 2 Cir., 130 F. (2d) 149 (1942) and *U. S.* v. *Penn Mut. Life Ins. Co.*, 3 Cir., 130 F. (2d) 495 (1942).

Vance, in his treatise on insurance, has written:

> "It may be said that, as a general rule, the policy is not to be regarded as liable to seizure under any form of judicial process against the insured so long as the duty of the insurer to pay is subject to any contingency, or to any condition precedent. Such condition may be under the control of the insurer, as where the policy gives to the insurer the power to elect between several optional forms of settlement; or where it permits the insured to fix the debt of the insurer by electing to receive cash, or a paid-up policy, or some other optional benefit. Until such option is exercised in favor of a cash payment, the insurer cannot be said to be so indebted to the

> insured as to be subject to garnishment. But where the only condition to the insurer's promise to pay an agreed surrender value is the insured's giving up the policy for cancellation, the Courts generally permit the attaching creditor to deliver up the policy and receive the surrender value." Vance, Insurance (2d Ed.), Section 161, page 615, et seq.

It may be conceded that, in a proper action during the insured's lifetime, the Government can compel the insured to surrender the policy, and thereby recover the cash surrender value, see *U. S.* v. *Roark*, D. C., West. Dist. Mo., So. West. Div., decided 7/17/57, 57-2 USTC No. 9883, *U. S.* v. *Metropolitan Life Ins. Co.*, 2 Cir., 130 F. (2d) 149.

Until recently it has been held that unless the Court could act in personam upon the insured, the Court was powerless to enter judgment against the insurance company for the surrender value when the Government sought to enforce its lien for taxes of the insured. Recently, however, in the case of an absconding taxpayer, who had been convicted of income tax fraud, the Court of Appeals, 4 Cir., directed the insurance company to pay the cash surrender value to the Government, ruling that the judgment of the Court had the effect of relieving the insurance company of its obligation under the insurance contract, see *U. S.* v. *Metropolitan Life Ins. Co.*, 4 Cir., decided 1/14/58, 58-1 USTC No. 9238.

It does not follow, however, that the surrender value can be followed after death of the insured has terminated his option to receive it. In *U. S.* v. *The Penn Mutual Life Ins. Co.*, 3 Cir., 130 F. (2d) 495 (1942), it was held that when the policy lapsed, after distraint for taxes was served upon the insurance company, and extended insurance was

issued, there no longer was any cash surrender value to be recovered by the Government.

In *U. S.* v. *Behrens*, 230 F. (2d) 504, 2 Cir., affirming 103 F. Supp. 93, cert. den. 351 U. S. 919, the Court of Appeals upheld the decision of the District Court for New York that a tax lien arose against an insured taxpayer, under Section 3670, which attached to the cash surrender value and followed into the insurance proceeds. Adopting and following the ruling in *Behrens*, the Court in *U. S.* vs. *Hoper*, 242 F. (2d) 468, 7 Cir., reversed the District Court for Illinois, 144 F. Supp. 281, which disagreed with and refused to follow the ruling in *Behrens*.

The Court of Appeals in the *Behrens* case in its opinion discusses the legal rights with respect to cash surrender value of life insurance policies and concludes:

> "It follows from what we have said that there is no logical escape from holding that the 'surrender value' comes to an end on the insured's death, if we dispose of the controversy in accordance with the ordinary rules governing contracts." 230 F. (2d) 504, 506.

Immediately after the statement above quoted is the following:

> "(3) However, in Rowen *v.* Commissioner, supra (p. 647), we held that 'it is not realistic to view his' the insured's 'death as wiping out these values. Under the policies his death was merely a condition upon which the surrender values no longer payable to the decedent became merged in the greater values which the insurers were obligated to pay the beneficiaries.' There can be no doubt that the courts have spoken of the 'surrender value' as though it were in fact a fund which the insurer held as a custodian for

the insured. This way of looking at the situation was long ago stated by Judge Addison Brown[3] with his customary clarity and the Supreme Court has twice quoted what he said with approval.[4] We shall not requote it in full; it is enough to excerpt the following passages. 'Though this excess of premiums paid is legally the sole property of the company, still in practical effect, though not in law, it is the moneys of the assured deposited with the company in advance to make up the deficiency in later premiums. So long as the policy remains in force, the company has not practically any beneficial interest in it, except as its custodian with the obligation to maintain it unimpaired and suitably invested for the benefit of the insured. This is the practical, though not the legal relation of the company to this fund.' This language obviously treats the surplus of the paid premiums that makes up the 'surrender value', as a 'fund' held for the insured, and, if it were such, the lien would follow it into the 'proceeds'. Regardless of what Judge Medina and I might have held, had the question come up as *res nova*, we think that this interpretation is imperative, and therefore we all agree that the 'proceeds' were subject to the lien.'' (230 F. (2d) 504, 506, 507).

The authorities cited in *Behrens*, namely, Judge Brown's decision in *In re McKinney*, 15 Fed. Rep. 535, 537, *Hiscock* v. *Mertens*, 205 U. S. 202, 211, 212, and *Burlingham* v. *Crouse*, 228 U. S. 459, 469, are bankruptcy cases in which the question presented was whether and to what extent the trustee in bankruptcy acquired the ownership of the cash surrender value of the bankrupt's life insurance.

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[3] *In re M'Kinney*, 15 Fed. Rep. 535, 537.

[4] *Hiscock* v. *Mertens*, 205 U. S. 202, 211, 212; *Burlingham* v. *Crouse*, 228 U. S. 459, 469.

In *McKinney* the facts disclose that the bankrupt actually assigned his policy, which named his executors and assigns as the beneficiary, to the Trustee. The Court held that as a result of the assignment of the policy the trustee became the owner to the extent of the cash surrender value, and was entitled to collect a portion of the proceeds, only to that extent.

The *Hiscock* and *Burlingham* cases arose at a time when the bankruptcy act specifically vested the trustee with ownership of all of the bankrupt's property, but provided that the bankrupt might retain, or re-acquire, his life insurance policies upon paying the cash surrender value to the trustee.

Clearly, then, in all three cases, *McKinney*, *Hiscock* and *Burlingham*, there had been an actual conversion of ownership, of the policy, either by actual assignment as in McKinney or by statutory effect as in *Hiscock* and *Burlingham*.

Actual conversion of ownership might possibly create a trust in favor of the new owner on the theory that it was intended by the act of conversion to benefit the new owner to the extent of the surrender value at time of conversion.

It does not follow, however, that a mere lien, if one arose in the instant case, without conversion into ownership vests the lienor with ownership of the surrender value. Nor, does it follow that a lien upon the insured's contractual right to surrender the policy for cancellation, obviously exercisable only during life, to receive the surrender value, vests the lienor with any right to the proceeds, or any portion thereof, after the death of the insured has definitely terminated the right to receive the surrender value. Cer-

tainly, the liener's rights can rise no higher than those of the licnee.

For the reasons stated, it is respectfully urged, that the decision of the Court in *Behrens* is unsound and without merit.

Since the *Behrens* decision was adopted and followed in *U. S.* vs. *Hoper*, 242 F. (2d) 468, the same arguments apply.

The cross-petitioner, with further reference to the *Behrens* and *Hoper* cases, points out that she relies primarily upon her rights under the contract of insurance as construed by the Courts of New Jersey, and only secondarily upon the statutes, R. S. 17:34-28 and R. S. 17:34-29, *supra*, page

## POINT 5.

**The cross-petitioner is under no circumstances liable as transferee to the full extent of the net proceeds of the policies.**

The District Court entered judgment in the amount of $11,657.30, interpreting *Pearlman* v. *Commissioner*, 153 F. (2d) 560, to hold that the beneficiary was a transferee of the proceeds. The Court below stated that such a conclusion was not warranted by the "Pearlman decision nor is it supported by more recent cases" (Opinion, R. 21). The Court below decided that cross-petitioner was a transferee only of the cash surrender value and directed that judgment be reduced to $3,362.53.

There have been a number of decisions in lower Courts which construed the *Pearlman* case as extending the liability to the full amount of the proceeds. However, all appellate courts agree that the extent of liability is limited to an amount less than the proceeds. The Court of Appeals, 7 Cir., in *United States* v. *New*, 217 F. 2d 166 (1954), reversed the District Court and expressed its rejection of the Government's contention in the following language adopted from *Rowen* v. *Commissioner*, 215 F. 2d at page 644:

> "In no sense were the proceeds ever property of the decedent-taxpayer. Under the policy contracts the decedent never had a right to receive the proceeds. And since at his death, the policies were not payable to his estate, the proceeds of the policies never passed to his estate, and as to the proceeds the beneficiaries did not take as legatees or distributees of his estate." 217 F. 2d 166, 167.

The Court of Appeals, 10 Cir., in a case which did not involve life insurance, *Voss* v. *Wiseman*, 234 F. 2d 237 (1956), held that the liability of a transferee, "where such liability is established", is limited to the amount of the transfer, plus the proper amount of interest applicable to the particular case.

See also *Glenn*, Fraudulent Conveyances and Preferences, *supra*, pages 14, 15.

In no event can the liability exceed either the amount of premiums or the cash surrender value of the policies.

## Conclusion.

**For the reasons stated, it is respectfully submitted that the cross-petitioner is under no liability to the United States of America, and that the judgment below should be revised accordingly.**

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